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SUBJECT: KAZAKHSTAN: A KCTS SCORECARD OF RISKS AND REWARDS

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11. (U) Sensitive but unclassified. Not for public Internet.

12. (SBU) SUMMARY: From April 7-17, Energy Officer accompanied a definitional mission from the U.S. Trade and Development Agency to identify potential technical assistance projects in support of the Kazakhstan Caspian Transportation System (KCTS). During the course of that mission, Energy Officer traveled to Atyrau, Aktau, Kuryk, and Bautino on the Kazakhstani shores of the Caspian, discussing the cross-Caspian transportation of oil with international oil company (IOC) executives, port authorities, shipping companies, local government officials, and Western diplomats. Reftel reports on current and future infrastructure investments associated with the development of KCTS. This cable draws upon those conversations and observations to provide an updated scorecard of the players, and their positions, in KCTS. Negotiations among KMG, SOCAR, and the IOCs have intensified in recent weeks and major decisions must be made soon if the system is to be ready in time for first oil from Kashagan in 2013. The most critical issues to be resolved are the construction of tankers to transport Tengiz and Kashagan crude volumes across the Caspian and the nature of IOC participation in the project. It also remains to be seen whether Russia will influence the development of KCTS, perhaps by building the large tankers called for by the IOCs, or shipping vessel modules through the Volga-Don canal. END SUMMARY.

KCTS IS IN THE EYE OF THE BEHOLDER

13. (SBU) KCTS is a simple concept, but an incredibly complex project. Its success requires billions of dollars of investment, concerted diplomatic effort, new institutions and infrastructure, and a level of trust and cooperation among national oil companies, government ministries, local officials, and international oil companies not seen since the early days of the Baku-Tbilisi-Ceyhan (BTC) pipeline. In its fullest form, KCTS will transport more than one million barrels of crude each day by pipeline from Eskene near the oilfields to Kuryk on Kazakhstan's Caspian coast, load it onto

large tankers, ship it to Baku, and pump it into the BTC pipeline, where the crude will be sold on the world market. But KCTS means different things to different people. Some argue, for example, that existing infrastructure -- such as oil loading terminals at Aktau and Baku -- should be excluded. Others say that smaller tankers should continue to be used, at least in the beginning. There are many permutations of the project, and the definition of KCTS depends on who is talking, and what they have at stake.

INTERNATIONAL OIL COMPANIES

14. (SBU) The IOCs know that they need an outlet for future oil production from Tengiz and Kashagan, even if pipelines via Russia and China are expanded as planned. But the companies say they will not commit crude volumes to KCTS unless they have equity in the Eskene-Kuryk pipeline and the trans-Caspian project (the marine portion from terminal to ship to terminal). Although the IOCs are not in the shipping business, they insist that partial ownership of vessels, buoys, and docks will help control risk, cost, and safety. They are clearly wary of Azerbaijani assurances that fees and tariffs will be transparent, fixed, and reasonable. Furthermore, if there is an oil spill in the Caspian, they know that the media spotlight will be on the Western majors, not the parastatal bystanders. IOCs insist on using large, 63,000 deadweight ton tankers with trained crews operating according to international standards in order to increase safety and reduce risk. They will likely end up financing the majority of the project, which could cost as much as \$9 billion, including the Eskene-Kuryk pipeline.

KAZMUNAIGAS

15. (SBU) KMG needs KCTS as much as the international companies do, if not more so. As an equal partner in the Kashagan consortium, KMG must export its production volumes as safely and efficiently as possible. In addition, as a national oil company, KMG has a larger

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strategic interest in ensuring the development of an alternative export route that is not controlled by any one country. KCTS, from KMG's perspective, will provide that flexibility by theoretically enabling Kashagan crude to be shipped in three directions: Baku, Makhachkala (Russia), and Neka (Iran). The risk to KMG is that SOCAR, its joint venture partner in the project, will squeeze tariffs and extract rent from KCTS at every turn, severely reducing the netback price for crude shipments from Kazakhstan. KMG is also concerned about ceding control or majority ownership of KCTS infrastructure assets that will be built in Kazakhstan, such as ports and terminals.

THE STATE OIL COMPANY OF THE REPUBLIC OF AZERBAIJAN

16. (SBU) Azerbaijan is absolutely essential to the success of KCTS and SOCAR knows it. SOCAR will hold out as long as it can, enjoying the advantage of geography, comforted by the thought that Kazakhstan's producers will become more willing to negotiate tariff terms and service fees as the date of early oil from Kashagan approaches. The risk for SOCAR is that if they wait too long, they will own and operate a large -- and largely empty -- pipeline from Baku to Ceyhan, as oil production from Shah Deniz and Azeri-Chirag-Gunashli declines. In addition, KMG and Kashagan's European partners Eni and Total have spoken openly about shipping crude to Neka instead of Baku, although the MOU between Azerbaijan and Kazakhstan requires "mutual agreement" on shipping destinations other than Baku. Finally, it is worth noting that a number of influential Azerbaijani shipping companies have a vested interest in maintaining the status quo of a smaller, older tanker fleet. These stakeholders will not be eager to go out of business and will want a piece of the action even if new, large tankers are used.

MINISTRY OF ENERGY AND MINERAL RESOURCES

17. (SBU) Recent comments from Minister of Energy Mynbayev and Vice Minister Kiinov indicate that Kazakhstan's Ministry of Energy (MEMR) takes a more conservative, if not skeptical, view of KCTS. As a government agency, it is keenly aware of the political implications of developing an oil export route that circumvents Russia. The

Ministry is no doubt wary of needlessly annoying their neighbors to the north with public statements extolling the virtues of trans-Caspian shipping. MEMR is likely also concerned about the fiscal and political wisdom of embarking on a multi-billion dollar project during a severe economic crisis. Mynbayev struck a populist pose when he insisted that the government will retain a majority (51 percent) stake in the pipeline portion of the project (i.e., the Eskene-Kuryk pipeline). Nevertheless, if MEMR were to be convinced of both the urgency and benefits of the project -- and if the IOCs said they would pay for it -- MEMR could become an ardent champion. Certainly, the Ministry understands the importance of finding an outlet for oil from Kashagan, upon which so much of Kazakhstan's future development depends. Unlike the 30-somethings who run KMG and KazMorTransFlot, MEMR is managed by a trusted old guard of veteran oilmen who will undoubtedly weigh in with President Nazarbayev when he makes the final decision about when, where, and whether to move forward with KCTS.

LOCAL GOVERNMENTS

18. (SBU) For the regional government of Mangistau oblast and local officials there, KCTS is a gold mine waiting to be discovered -- and divided. In their eyes, the project has the power to modernize infrastructure, triple the population, create thousands of jobs, and transform sleepy towns into bustling port cities. It will quite literally put Kuryk on the map. The risk for local governments is that the project will not go forward for political, financial, technical, or other reasons -- a risk only increased by recent reports of infighting among authorities. On April 24, Kazakhstan's Procurator General annulled a decision by the mayor of Kuryk to lease 16.77 hectares of coastal land to Ersai Caspian Contractors, a 50-50 joint venture of Italy's Saipem and Kazakhstan's ERC Holdings, for 48.2 million tenge (\$321,333). The head of the local administration of neighboring Karakiyanski raion protested the

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decision and appealed to the Procurator General, who ruled that the land is legally considered part of Kazakhstan's territorial waters and therefore the rights to its use and disposition may be decided only by the central government.

THE RUSSIAN TRUMP CARD

19. (SBU) Would Russia support a project that is designed to circumvent its territory and reduce its control over energy exports from the region? Russian sensitivities about alternative energy export routes from Central Asia are indeed high. In a meeting with the Ambassador on April 29, Russian Ambassador Mikhail Bocharnikov alleged that the United States has urged that no oil should flow from Kazakhstan through Russia and should instead be sent to China. Yet Russian opposition to KCTS has been surprisingly muted, perhaps because the project is largely undefined and unfunded. It is still not clear, for example, what size tankers will be used, where they will be built and assembled, and who will pay for them. The Russian government would clearly prefer Kazakhstani crude to transit Russian territory, which explains its support for the expansion of Caspian Pipeline Consortium (CPC) pipeline, expansion of the Atyrau-Samara pipeline, and establishment of a quality bank system for exports from the Black Sea port of Novorossiysk. These measures will ensure that, even once KCTS becomes a reality, the majority of Kazakhstan's oil will continue to go through Russia. Nevertheless, there are several ways in which Russia could participate in (and have leverage over) KCTS. For example, Russian shipyards in Astrakhan, Nizhny Novgorod, or St. Petersburg could be contracted to build the 63,000 dwt tankers. Alternatively, if the ships are built outside the Caspian, for example in South Korea, the modules would have to be delivered to the Caspian through the Volga-Don canal. No shipyard on the Caspian currently has the capability to build the large tankers that the IOCs insist are necessary to make the project safe and commercially viable. Russia therefore holds a tanker trump card that could determine the ultimate success of the project. It remains to be seen how and when they will play that card, but it is clear that the stakes will rise as Kashagan's production deadlines near.

MILAS